United States Court of Appeals

for the Second Circuit

REPLY BRIEF

Docket No. 76-4199

UNITED STATES COURT OF APPEALS for the
SECOND CIRCUIT

ANGELO J. and IDA A. BIANCHI,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

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P/S

REPLY BRIEF FOR TAXPAYER-APPELLANTS

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IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 76-4199

ANGELO J. and IDA A. BIANCHI,

Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,

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ON APPEAL FROM THE DECISION OF THE

UNITED STATES TAX COURT

REPLY BRIEF FOR THE TAXPAYER-APPELLANTS

Ordinarily, as counsel to taxpayer-appellants it would not be my plan to file a reply brief in a matter like this. However, the brief of the appellee Commissioner of Internal Revenue so plainly misstates the law and the facts herein that as attorney to the taxpayers I feel compelled to file this, which is truly a <u>reply</u> brief. That is, it will not bring up any new matter, but will simply reply to the errors of the Commissioner's brief.

Accordingly, and with what I hope will be the Court's permission in the interests of moving ahead, we are going to dispense with the usual Table of Contents and of Citations. (There are no new citations beyond those in the prior briefs herein, except for three cases which are fully cited when mentioned).

First, anyone reading the original brief of the taxpayer and the ostensibly "answering" brief of the Commissioner might initially conclude that they are for two different cases: the Commissioner's brief does not really answer the argument of the taxpayer, but argues another case.

At p. 11 of the Commissioner's answering brief, it is stated: "...the Tax Court was not bound to accept the testimony of the taxpayer and his witnesses that the taxpayer's salary was reasonable, under the circumstances, since the facts of record clearly contradict that allegation, as the Tax Court held: 'It cannot be questioned that the clearest evidence of the worth of petitioner's services is petitioner's earnings from his dentistry practice as an individual proprietor.' (R.95)"

But neither the learned Court below, nor the Commissioner can cite any authority for that proposition tossed in as a giant assumption--and one for which there is no factual basis whatsoever.

Indeed, all the evidence in this matter--the undisputed, unimpeached, unrebutted testimony--is to the effect that the pension and pension contribution in issue were both "ordinary and necessary" and that the compensation of the taxpayer, even when

the pension contribution allocable to him was added to his direct remuneration, was on an overall historical basis not high, but low. Our original brief at pp. 5-8 detailedly reviewed all of this testimony.

One cannot meet a body of undisputed, unrebutted, unimpeached testimony like that by simply repeating a giant assumption without one iota of factual support on the record: that the best evidence of the value of a man's services is what in fact he earned.

Plainly and despite such a chance observation having been made by the Court below, that is ridiculous. For were it true we would never have an "unreasonable compensation" dispute: if a man is truly worth precisely what he in fact earned, where is the basis for disallowing some of his supposed "compensation" as excessive and unreasonable? Again, if a man is worth precisely what he earns, why should the present salaries of our judges in the Federal judiciary be raised?

If one is to appeal to "common sense" as the learned judge below assertedly did on this matter, we suggest it is a matter of notoriety that some men are at any particular point overpaid whereas others are substantially underpaid, on account of <u>many</u> factors. Some of those factors were present in our case: the case of a new professional embarking on a new profession and investing considerable time in improving his knowledge and skills. <u>Every</u> form of investment involves some deferral of income that could otherwise currently be earned or enjoyed. The professional by studying, going to schools, attending seminars, reading

journals, particularly in his early years, invests his <u>time</u>--time in which he could otherwise be rendering billable services and earning money.

If "...the facts of record clearly contradicted the allegation" (of reasonable <u>historical</u> compensation) as the Commissioner's brief assets at p. 11, why cannot such brief "clearly" point to any of such evidence, other than the schedule of actual earnings, which, as we have noted, simply do not prove his blithe assumption and the Court's below: that "...the best evidence of the reasonability (sic) of the taxpayer's compensation is the amount which he was able to earn for himself in the period preceding incorporation...." (Commissioner's brief at p. 12).

At p. 12 the Commissioner's brief cites <u>Willmark Service System, Inc. v. Comm'r</u>, 368 F2d 359 (CA-2 1966) for the settled law that the Tax Court's findings on an "unreasonable compensation" issue should not be disturbed unless they are "clearly erroneous". We do not argue with that principle nor the <u>Willmark</u> case.

Simply, it is not our case <u>at all</u>. In <u>Willmark</u> the Second Circuit noted in the third sentence from the end of the decision: "(Taxpayer) made no attempt to establish that the salaries paid Mark and William were inadequate or that the payments to the widow were reasonable." There all the taxpayer in effect did was to slap down on the courtroom table a contract obligating the corporation to continue payments to the widow of one "partner" in an agreed percentage of the compensation from time to time paid the surviving "partner". It offered no evidence as to the factors

noted above by the Second Circuit which might have justified the payments, but simply rested on the bare contract. In sum, this was a burden of proof case. And one in which the taxpayer presented no real evidence of "reasonableness".

Obviously, that is not the instant case at all, one in which there was detailed testimony of several witnesses for the taxpayer on the "reasonableness" issue. And one in which such evidence was never disputed, rebutted or impeached in any way by the Commissioner.

The cases really in point thus are the six cases cited by us at pp. 8 through 10 of our original brief, cases which the Commissioner's brief wholly fails to comment on, much less distinguish.

At p. 13 of his brief the Commissioner asserts that the taxpayer's situation "...had nothing in common with the usual 'reasonable compensation' case, where the recipients are able to establish that prior salaries were lower than normal because the recipients desired that the corporation's profits be used to expand the business." Here, in citing R. J. Nicholl Co. v. Comm'r, 59 TC 37 (1972), the Commissioner fails to recognize that forming human capital is fully as important in service businesses and professions as is forming tangible capital in commercial businesses. We have abundant evidence that the taxpayer went to several professional schools, attended many seminars and clinics, studied journals, all to develop further human capital. What the Commissioner forgets was stated by Adam Smith 201 years ago in his Wealth of Nations: "The acquisition of such talents, by the maintenance of the acquirer during his education, study or apprenticeship always costs

a real expense, which is a capital fixed and realized, as it were, in his person."

In addition to the actual "maintenance of the acquirer" (board and lodging, fees and books), there is also the economic cost of the earnings the "acquirer" could otherwise have earned during such education. And that is plainly one reason why the earnings of new professionals in any field are typically low: they are still building up "human capital". In sum, Nicholl is distinguishable: it deals with tangible capital while the instant case deals with building up human capital. But is that a distinction which should lead to a difference in legal result?

On page 14 the Commissioner puts forth a proposition of supposed "law" which the cases (other than U.S. Asiatic Co. v. Comm'r, 30 TC 1373 (1958), which we discussed at length at pp. 12 and 13 of our prior brief) simply do not support. It is less than intellectually honest to say that "...those courts which have considered the matter..." have upheld the IRS position that low earnings paid to or received by a taxpayer cannot be taken into account when considering what earnings may be paid that same person after incorporation by a successor corporation. As noted in our brief, one fragile, ill-reasoned, virtually uncited (for this proposition) case so holds: U.S. Asiatic Co. In contrast, R. J. Nicholl Co., supra, cited by the Court below and by the Commissioner holds plainly to the contrary. As does dictum in this Circuit's own Bongiovanni v. Comm'r, 470 F2d 921, 925 (CA-2 1972), rev'g TC Memo 1971-262, 30 TCM 1124, cited by us in our brief at p. 14.

The Tax Court in R. J. Nicholl Co. permitted a deduction by the successor taxpayer because (at 59 TC 51): "Although the prior services were rendered to the predecessor corporations, it is obvious that R. J. Nicholl Co. was a direct beneficiary of these prior undercompensated efforts by Raymond." So, too, in the instant case: the taxpayer's professional corporation was the beneficiary of the human capital the Doctor had developed by his exhaustive study and low earnings in his earlier years.

Again, the Tax Court in R. J. Nicholl Co. notes (at 59 TC 52): "In this case, although not formally expressed in the nature of a corporate resolution, there is specific testimony, based upon facts which we have found, that Raymond was undercompensated in the early years so that the corporation could retain the needed cash and that the brothers expected to reap the ...benefits for these undercompensated services in later years." We have comparable evidence in the instant case of a professional who studied hard and long expecting such studies eventually to pay off in higher earnings. And when those well deserved earnings do eventuate, as here, why should not the professional--whether working as a self-employed person or for a professional corporation--not be permitted to take and enjoy them?

At p. 14 the Commissioner cites Underwriters' Laboratories, Inc. v. Comm'r, 46 BTA 464 (1942) as ostensibly supporting its position that a successor employer cannot make up for undercompensation paid to certain employees by a predecessor employer. Plainly, the Commissioner's counsel did not read our brief at p. 12 which showed, even as we did in the brief below to the Tax

Court, that such case is simply not in point. Its headnote 2, which is a fair statement of this issue, reads: "Held, petitioner is not entitled to a deduction as a business expense of an amount paid on account of premiums for employees' pension and disability policy of insurance, such payment having been made by its predecessor." There it was held that the successor employer cannot claim a deduction for an item concededly in fact paid by the predecessor. Plainly, that is not our case at all.

Then the Commissioner cites a mish-mash of revenue rulings, most not in point, as if to admit the paucity of authority for its position. Rev. Rul. 71-502, 1971-2 C.B. 199 _is_ admittedly in point. But is it correct? It rests solely on Rev. Rul. 69-36, 1969-1 C.B. 128. In such earlier ruling a proprietor with a Keogh plan thereafter incorporated his business or practice and attempted to continue the same plan as that of the corporate successor employer. The retirement plan continued the same two-year prior service requirement and explicitly took into account service in any capacity for the prior employer as counting for such requirement.

As authority for the IRS opinion that such a plan would no longer be a "qualified plan" as to the successor corporate employer, the Service cited a provision of its then "bible" on qualified plans generally: Part 2(j)(1) of Rev. Rul. 65-178, 1965-2 C.B. 94. This was later replaced by Rev. Rul. 69-421, 1969-2 C.B. 59, cited in the Commissioner's brief at p. 14, which contains the same precise text for its Part 2(j)(1):

> Except to the limited extent applicable to the participation of self-employed individuals after December 31, 1972, partners and sole proprietors are not employees and therefore are not eligible to participate in qualified plans. Neither are they to be credited for services as partners or sole proprietors prior to becoming employees in a successor corporation, either for prior service benefits or for meeting eligibility requirements. See Rev. Rul. 69-144.

It is interesting, however, to note that every court which has considered this IRS position has uniformly rejected it and has held that service prior to incorporation may properly be taken into account. We did not cite this extensive jurisprudence in our original brief because we did not think the Commissioner would have the gall to contest it now, particularly in the context of the Treasury's published acquiescence in the last of those cases, Farley Funeral Home, Inc. v. Comm'r, 62 TC 150 (1974), Acq., 1975-4 IRB p. 5.

The other cases which have held this IRS position to be error are U.S. v. Kintner, 216 F2d 418 (CA-9 1954), Sherman Construction Corp. v. U.S., not officially reported, 73-1 USTC Par. 9258 (D.C., E. Dist. Va., 1973), and, of course, the Tax Court decision below in this very case. The celebrated Kintner case decided this as a largely overlooked (by most students of tax jurisprudence) second issue: retirement plan of the Western Montana Medical Clinic could take into account service (or "tenure") of its self-employed partners prior to becoming an "association taxable as corporation" (first issue of the case) for meeting a prior-service requirement in such corporate qualified plan.

Again, if Part 2(j)(1) of Rev. Rul. 69-144 was once the IRS position, has it not in effect been reversed sub silentio by the Treasury's acquiescence in Farley Funeral Homes, Inc.?

In any event, in the context of the cited decided cases and such acquiescence, these old revenue rulings are not very persuasive: plainly they've persuaded not one court, including the Tax Court in the instant case.

Admitted, one can distinguish all such cases (except for the suggestion in the Tax Court decision below) from the instant case on the ground that the other cases dealt with a prior-service requirement, while the instant case in effect would take earnings (or low earnings) prior to incorporation into account in determining the propriety of plan contributions--and thus eventual benefits--after incorporation.

Recall that Part 2(j)(1) above-cited said that prior service could not be taken into account"..either for prior service benefits or for meeting eligibility requirements." The cases prior to this one admittedly only are holdings on the "eligibility requirements" aspect of such IRS opinion and do not explicitly reach the "prior service benefits" aspect.

However, one can surmise that the reason why the learned judge below did not summarily dispose of taxpayer's petition by simply and succinctly holding Part 2(j)(1) applicable--as urged by the Commissioner--was that he found it illogical to allow a successor corporate employer to take into account for a self-employed person his service prior to incorporation but not to allow plan benefits to take into account his earnings (or lack

of them) prior to incorporation. Why should the one be taken into account, but not the other?

Probably we all should have realized just how fragile was the legal basis for such Part 2(j)(1) of Rev. Rul. 69-421 when we noted that its one bit of cited authority was Rev. Rul. 69-144, 1969-13 I.R.B. 9.--which is again cited in the Commissioner's brief at p. 14. Such revenue ruling is not in point: it simply holds that a partnership qualified plan can cover common-law employees although they are relatives of the partners. This is the sole supposed "authority" for the IRS position it has clutched so tenaciously in the face of consistent rebuffs from the courts.

The final revenue ruling cited by the Commissioner's brief at its p. 14 is Rev. Rul. 69-36, 1969-1 C.B. 128. Admittedly, this is close to being in point. But is it correct? It holds that upon the incorporation of a proprietorship the former proprietor, now an employee, may not take into account service prior to incorporation for a prior-service requirement in a qualified plan. First, whatever merit this position might have had, it has been shot to pieces by the three cases cited and the recent Treasury acquiescence in Farley Funeral Home, Inc. Second, it cites as its sole authority Part 2(j)(1) to Rev. Rul. 65-178 (which was, as previously noted, precisely restated in Rev. Rul. 69-421). Here is a circularity of argument. Even as such Part 2 (j)(1) is wholly discredited, so too is any revenue ruling which depends on it.

Basically, this is a very simple case, despite the suggestions of the Commissioner's brief to the contrary. This is a

"reasonable comp" case. Ultimately, "reasonable comp" is always a question of fact. The taxpayer admittedly has the burden of proof on such issue. But when, as here, the taxpayer has put in extensive, uncontradicted, unrebutted, unimpeached evidence from several witnesses that the compensation paid a key executive for "personal services actually rendered in prior years as well as the current year" (Treas. Reg. Sec. 1.404(a)-1(b), cited more extensively by the Commissioner's brief at its p. 15) was not high, but rather low, the taxpayer has met his burden of proof. Accordingly, as set out in the six cases cited by us at pp. 8 through 10 of our original brief herein, it is "clearly erroneous" for a trial court in such a context to hold such compensation "unreasonable".

Unless, of course, there is some sound rule of law which forbids this Court to take into account undercompensation in the years prior to incorporation. The court below felt there was such a sound rule of law.

It felt itself controlled by *U.S. Asiatic Co. v. Comm'r*, which we discussed at length in our brief at pp. 12 and 13. And while it recognized that the more recent and better articulated *R. J. Nicholl Co.* case, *supra*, was to the contrary, it felt such latter case distinguishable, failing to realize that investment in human capital in a service business or profession is just as important as investment in tangible capital, as was done in the *Nicholl Co.* situation. We cede there is a distinction between such case and the instant case: but we do not see why it should lead to a difference in legal result.

Again, our entire Point II which the Commissioner's "answering" brief fails to answer, is that "A Successor Corporation to an Unincorporated Trade or Business May Properly Pay and Deduct Expenses Economically Attributable to the Pre-Incorporation Period." Since we promised that this brief would be strictly a "reply" brief, we shall not repeat this extensive argument and citation to authority, with only one special request of the Court: that it read and consider the hypothetical case put at p. 20 of our brief, which reproduced p. 17 from our brief to the Tax Court.

We do not believe there is any answer to that hypothetical. None was offered by the Commissioner in his briefs to the Tax Court, none was offered by the learned Tax Court, none was offered by the Commissioner's "answering" brief herein. Do we have to engraft another anomalous and arbitrary quirk on the Code in refusing to take into account the building years of low earnings any professional normally goes through when he later incorporates and is paid an amount which, when looked at alone and forgetting the lean prior years, might seem to be excessive and "unreasonable"?

Why? Cannot fairness and common sense and equity allow us to take all years into account when deciding, as here, an alleged "unreasonable comp" case?

For the reasons stated, we respectfully pray that the Court reverse the decision of the Tax Court.

Respectfully submitted,

January 26, 1977

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CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 1st day of February, 1977, in an envelope, with postage prepaid, properly addressed to him as follows:

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